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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1951

No. 614

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE, HARRIET H. BELCHER and LILLIE S. WEGEFORTH,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Court of Appeals for the Ninth Circuit
AND
BRIEF IN SUPPORT THEREOF.

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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI to the United States Court of Appeals for the Ninth Circuit.

To the Honorable Fred M. Vinson, Chief Justice of the United States, and to the Honorable Associate Justices of the Supreme Court of the United States of America:

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered November 5, 1951 (R. 255),

rehearing denied January 3, 1952 (R. 256), which reversed the decisions of The Tax Court of the United States entered March 14, 1950. (R. 118, 150, 187, 205, 236.)

OPINION BELOW.

The opinion of the Court below, filed November 5, 1951, is reported at 192 F. (2d) 785, and a copy will also be found in the printed Transcript of Record at pages 250-254. The opinion of The Tax Court of the United States is reported at 13 T. C. 984, and a copy will also be found in the printed Transcript of Record at pages 64-98, together with the concurring opinion (R. 98-101) and the dissenting opinion. (R. 102-117.) There were two other issues before the Tax Court which are referred to in the stipulation of facts upon which the case was tried (R. 22-56) as issue No. 1 and issue No. 3. The only issue from which an appeal was taken is issue No. 2, which is the issue first considered by the Tax Court on pages 984 to 994 of the official report. (R. 69-85.)

BASIS OF JURISDICTION.

The jurisdiction of this Court is invoked under section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938. (Appendix, p. i.)

The judgment of the Court of Appeals for the Ninth Circuit was filed November 5, 1951 (R. 255); petition for rehearing was filed on December 4, 1951, and denied on January 3, 1952. (R. 256.)

SUMMARY STATEMENT.

The question involved in this case is whether the petitioners, who were stockholders of J. D. and A. B. Spreckels Company, hereinafter referred to as Spreckels Company, are subject to income tax upon distributions received by them during the years 1938, 1939 and 1940 to the extent that such distributions exceeded the current earnings of the corporation. The cases of other stockholders are pending in the Court of Appeals for the Ninth Circuit and will be controlled by the disposition of this case. Taxes of all stockholders for the years following 1940 to and including 1948, in which year the Spreckels Company was liquidated, will also be controlled by the disposition of this case.

The specific question presented is whether the impaired capital of a corporation caused by pre-March 1, 1913 operating losses must be restored out of subsequent earnings or profits before any earnings or profits can be accumulated within the meaning of section 115(a)(1) of the Internal Revenue Code. (53 Stat. 46). (Appendix, p. iv.) The Tax Court, in a decision concurred in by 13 of the 16 judges, held that the capital impairment must be restored. The Court of Appeals reversed.

The facts relating to this issue were stipulated, and are as follows:

The Spreckels Company had two subsidiaries with impaired capital as of March 1, 1913. These were Oceanic Steamship Company (hereinafter referred to as Oceanic) with an operating deficit on March 1, 1913 of $4,878,987.40

(R. 31[1]) and Kilauea Sugar Plantation Company (hereinafter referred to as Kilauea) with an operating deficit on March 1, 1913 of $308,429.18. (R. 31.) The Spreckels Company received distributions from these two corporations subsequent to March 1, 1913 and prior to the years here involved. The determination of the accumulated earnings or profits of the Spreckels Company available for dividends during the years 1938, 1939 and 1940 consequently depends upon whether the distributions it received from Oceanic and Kilauea were distributions of earnings or distributions of capital, and the resolution of this question depends in turn upon whether the impairment of capital of these two corporations existing on March 1, 1913 must be restored by subsequent earnings or profits. Furthermore, Oceanic was liquidated on November 18, 1936. (R. 31-32.) Since Oceanic was a wholly-owned subsidiary of the Spreckels Company, the liquidation was a nontaxable transaction under the provisions of section 112(b)(6) of the Revenue Act of 1936. (49 Stat. 1648, 1679.) (Appendix, p. iii.) Consequently under the rule of *Commissioner v. Sansome*, 2 Cir., 60 F. (2d) 931, the Spreckels Company inherited the accumulated earnings or profits of Oceanic. The extent of the accumulated earnings or profits thus inherited likewise depends upon whether its impairment of capital existing on March 1, 1913 must be restored by subsequent earnings or profits.

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[1]Issue number (1) referred to on this page of the Transcript of Record was decided in favor of petitioners.

The facts with respect to Oceanic are set forth in a schedule of the stipulation of facts. (R. 33-34[2].) This schedule shows that Oceanic realized earnings or profits of $6,830,763.76 between March 1, 1913 and March 15, 1922, on which date it declared its first dividend, and that these earnings were sufficient to restore the impaired capital and leave a balance of accumulated earnings or profits available for dividends in the amount of $1,951,776.36. This amount, together with subsequent earnings or profits, was sufficient to cover all dividends declared until the dividend of May 22, 1926, in the amount of $1,558,319.04. (R. 34.) The question of the restoration of impaired capital, therefore, does not become material until the declaration of this dividend. The Commissioner contends that the entire amount of this dividend increased the earnings or profits of the Spreckels Company (column 3), whereas the petitioners contend that this dividend was paid out of capital to the extent of $223,641.47 (column 1) and to this extent the dividend did not increase the earnings or profits of the Spreckels Company. No further dividends were declared by Oceanic prior to its liquidation on November 18, 1936. On that date, as shown by the schedule, the accumulated earnings or profits of Oceanic which were transferred to the Spreckels Company were $511,627.09 if the impaired capital is restored, as petitioners contend it must be. But, as the schedule also shows, if the Commissioner is correct in his contention that there can be an accumulation of earnings or profits

[2]Issue number 1 was decided in favor of petitioners; therefore columns 1 and 3 of this schedule are the two columns now material.

without the restoration of an impairment of capital, then the accumulated earnings or profits of Oceanic which were transferred upon liquidation to the Spreckels Company were $5,166,973.02.

The facts with respect to Kilauea are likewise set forth in a schedule of the stipulation of facts. (R. 36-37.) This schedule shows that Kilauea had an operating deficit of $308,429.18 on March 1, 1913, that it paid certain dividends during the years 1916 to 1936, inclusive, and that these dividends were paid out of capital to the extent of $370,000 if the impairment of capital represented by the operating deficit must be restored by subsequent earnings or profits, but that the distributions from capital were only $139,412.26 if the impairment of capital is not restored. The dividends which the Spreckels Company received from Kilauea increased the accumulated earnings or profits of the Spreckels Company only to the extent that they were paid out of earnings but not to the extent that they were distributions of capital.

The stipulation of facts contains schedules showing the apportionment of the distributions of the Spreckels Company between dividends from earnings or profits and distributions from capital depending on how the Tax Court resolved the three issues presented to it for decision, in any combination. Schedule 2 (R. 42-43) is the schedule which is applicable if the decision of the Tax Court was correct. This schedule shows that there is no longer any controversy with respect to dividends paid during 1938, all such dividends having been paid out of earnings or profits. This schedule also shows that, if the decision of the Tax Court was correct, the accumulated earnings or profits

of the Spreckels Company had been eliminated by the end of 1938, there being a small operating deficit on that date, and that distributions made during 1939 and 1940 exceeded the current earnings of each of those years and were distributions of capital to the extent of $1,551,373.99.

On the other hand, if the Court of Appeals was correct in holding that the capital impairment of the two subsidiaries did not have to be restored by subsequent earnings or profits, then schedule 5 (R. 48-49) is applicable. This schedule shows that, instead of a small operating deficit, the Spreckels Company would in such case have accumulated earnings or profits on December 31, 1938 exceeding $4,700,000 and that in consequence no distributions of capital were made in 1939 and 1940.

It will be observed from schedule 2 (R. 42-43), which is the applicable schedule if the decision of the Tax Court was correct, that the parties have stipulated that dividends paid by the Spreckels Company during 1939 and 1940 were taxable dividends to the petitioners to the full extent of the current earnings or profits in each of those years. No issue was raised with respect to the restoration of the small impairment of capital existing on December 31, 1938, which as shown by schedule 2 was $32,825.71.[3] Such restoration is not required under clause (2) of the definition of a dividend under which a taxable dividend may be declared from current earnings without regard to an operating deficit at the beginning of the year. Clause (2) was added by section 115(a) of the

[3]Even if petitioners had been successful with respect to all three issues presented to the Tax Court, the operating deficit on December 31, 1938 would only have been $33,437.76. See schedule 1. (R. 40-41.)

Revenue Act of 1936. (49 Stat. 1687.) (Appendix, p. iv.) The relatively small amount of income tax involved did not justify raising a question as to the constitutionality of clause (2).

QUESTIONS PRESENTED.

1. The question is whether, in the case of a corporation having an impairment of capital caused by pre-March 1, 1913 operating losses, the Court of Appeals for the Ninth Circuit was correct in construing section 115 (a)(1) of the Internal Revenue Code to mean that it is not necessary, in the determination of earnings or profits accumulated after February 28, 1913, to apply earnings or profits realized after that date to restore the impairment of capital.

2. If the Court of Appeals was correct in so construing section 115(a)(1), then the question is presented whether the Court of Appeals was likewise correct in deciding that its decision does not result in imposing an income tax upon the receipt of capital by the petitioners and does not result in imposing a tax which is beyond the terms of the Sixteenth Amendment to the Constitution and therefore a tax violative of Section 2 of Article I of the Constitution as constituting a direct tax not apportioned among the several states.

REASONS RELIED ON BY PETITIONERS IN SUPPORT OF THE ALLOWANCE OF A WRIT OF CERTIORARI.

1. The Court of Appeals for the Ninth Circuit has decided a federal question in a way probably in conflict with applicable decisions of this Court.

(a) The Court of Appeals decided that a corporation with an impairment of capital caused by pre-March 1, 1913 operating losses can have accumulated earnings or profits available for dividends without restoring the impairment of capital. In *Willcuts v. Milton Dairy Co.*, 275 U.S. 215, this Court held that, in the computation of "undivided profits" for excess profits tax purposes, profits which have been earned and retained in the business must be devoted to the restoration of an impairment of capital and do not constitute "undivided profits". The principle thus expressed is equally applicable to the determination of "earnings or profits" for income tax purposes and the *Milton Dairy* case has been frequently cited as authority in that connection.

(b) The Court of Appeals held that in the computation of earnings or profits accumulated after February 28, 1913 profits earned since that date are not to be applied to restore an operating deficit existing on that date but constitute accumulated earnings or profits available for dividends. This decision was based upon the Court's belief that "Congress drew a line between February 28, 1913 and March 1, 1913." In *Helvering v. Canfield*, 291 U.S. 163, this Court held that no such impenetrable line exists, and decided that in the computation of earnings or profits

accumulated after February 28, 1913 losses sustained since that date are to be applied to reduce an earned surplus existing on that date rather than deducted from profits earned in subsequent years.

2. The Court of Appeals for the Ninth Circuit has rendered a decision which conflicts, at least in principle, with the decision of the Court of Appeals for the Eighth Circuit in *Foley Securities Corp. v. Commissioner*, 106 F. (2d) 731. That Court held, on the authority of *Willcuts v. Milton Dairy Co., supra*, that in the determination of earnings or profits accumulated after February 28, 1913 an operating deficit must be restored by subsequent earnings. Although in the *Foley* case the operating deficit arose after 1913, the Circuit Court decided the case on the general principle established by *Willcuts v. Milton Dairy Co.* that where capital is impaired subsequent earnings or profits must be applied to offset the impairment. The Court below refused to apply this general principle.

3. The Court of Appeals for the Ninth Circuit has decided an important question of federal law which has not been, but should be, settled by this Court. The Court of Appeals held that distributions made by a corporation with an impaired capital and no undistributed earnings of the current year constitute income to the recipient within the meaning of the Sixteenth Amendment to the Constitution of the United States and that a tax imposed upon the receipt of such distributions is not a tax violative of Section 2 of Article I of the Constitution as constituting a direct tax not apportioned among the several states. We submit that it is of great general importance

that this Court, at every opportunity, define the line distinguishing capital from income so that taxpayers may be protected from an unconstitutional imposition of income taxes upon the receipt of capital.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Court of Appeals for the Ninth Circuit should be granted.

Dated, San Francisco, California,
February 20, 1952.

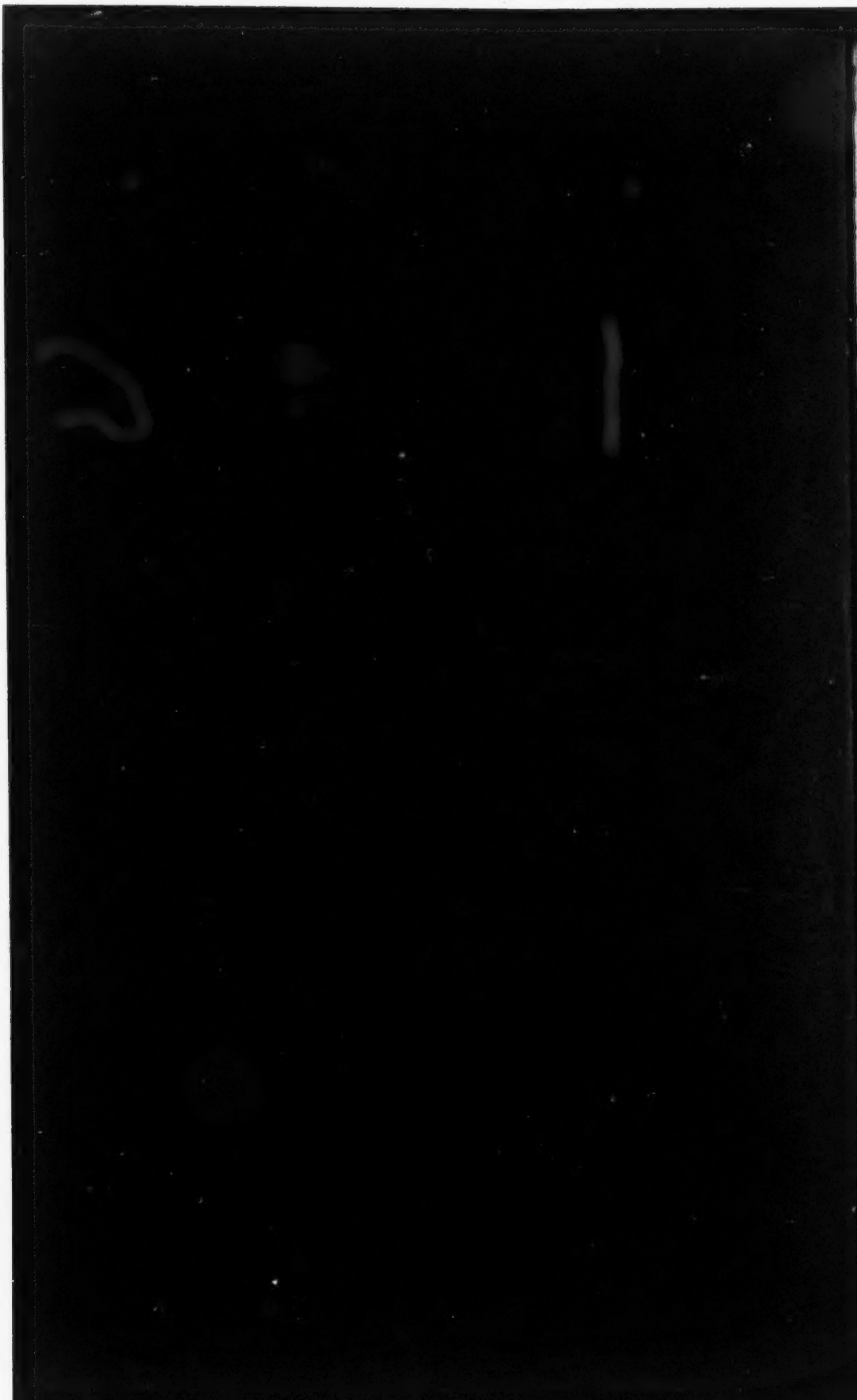
LEON DE FREMERY,
MORRISON, HOHFELD, FOERSTER,
SHUMAN & CLARK,
Attorneys for Petitioners.

CERTIFICATE OF COUNSEL.

I hereby certify that I am attorney for petitioners herein and that in my judgment the foregoing petition for a writ of certiorari is well founded and that it is not interposed for delay.

Dated, San Francisco, California,
February 20, 1952.

LEON DE FREMERY,
Attorney for Petitioners.



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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

JURISDICTION OF THE CASE.

The petition submitted herewith is filed to review the judgment of the United States Court of Appeals for the Ninth Circuit entered November 5, 1951 (R. 255), rehearing denied January 3, 1952 (R. 256), which reversed the decisions of The Tax Court of the United States entered March 14, 1950. (R. 118, 150, 187, 205, 236.) The opinion of the Tax Court (R. 64-98), together with the concurring

opinion (R. 98-101) and the dissenting opinion (R. 102-117), are reported at 13 T.C. 984. The opinion of the Court of Appeals filed November 5, 1951 is reported at 192 F. (2d) 785, and a copy will also be found in the printed Transcript of Record at pages 250-254.

The jurisdiction of this Court is invoked under section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938. (Appendix, p. i.) The reasons relied on for the allowance of a writ of certiorari are set forth in the foregoing petition at pages 9 to 11.

STATEMENT OF THE CASE.

A summary statement of the case, including the essential facts, is set forth in the foregoing petition at pages 3 to 8.

SPECIFICATION OF ERRORS.

1. The Court below erred in construing the words "earnings or profits accumulated after February 28, 1913" (section 115(a)(1), Internal Revenue Code, 53 Stat. 46) (Appendix, p. iv) to mean that an impairment of capital caused by pre-March 1, 1913 operating losses need not be restored by subsequent earnings or profits before there can be accumulated earnings or profits available for dividends.

2. The Court below erred in deciding that distributions made by a corporation with an impaired capital and no undistributed earnings of the current year constitute income to the recipient within the meaning of the Sixteenth

Amendment to the Constitution of the United States and that a tax imposed upon the receipt of such distributions is not a tax violative of Section 2 of Article I of the Constitution as constituting a direct tax not apportioned among the several states.

SUMMARY OF ARGUMENT.

I. *Reasons relied on by petitioners in support of the allowance of a writ of certiorari.*

1. The Court of Appeals for the Ninth Circuit has decided a federal question in a way probably in conflict with applicable decisions of this Court.

(a) The decision below conflicts, at least in principle, with *Willcuts v. Milton Dairy Co.*, 275 U.S. 215.

(b) The decision below conflicts in principle with *Helvering v. Canfield,* 291 U.S. 163.

2. The decision below conflicts, at least in principle, with the decision of the Court of Appeals for the Eighth Circuit in *Foley Securities Corp. v. Commissioner,* 106 F. (2d) 731.

3. The Court of Appeals has decided an important question of federal law which has not been, but should be, settled by this Court.

II. *A brief discussion of the merits.*

ARGUMENT.

I. REASONS RELIED ON BY PETITIONERS IN SUPPORT OF THE ALLOWANCE OF A WRIT OF CERTIORARI.

1. THE COURT OF APPEALS FOR THE NINTH CIRCUIT HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

(a) The decision below conflicts, at least in principle, with Willcuts v. Milton Dairy Co., 275 U. S. 215.

The question involved in *Willcuts v. Milton Dairy Co.*, 275 U.S. 215 (1927), was whether profits earned by the Dairy Company which were insufficient to offset an impairment of capital were "undivided profits" to be included as "invested capital" in computing the excess profits credit allowed by the Revenue Act of 1918. Section 326(a) of the Act (40 Stat. 1057, 1092) defined the term "invested capital" to include amounts paid in for stock and "(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year." At the end of 1917 an operating deficit of approximately $70,000 impaired the capital to that extent. The company had earnings in 1918 and 1919 which were not distributed and approximately $30,000 thereof remained in the business at the end of 1919 without having been applied to reduce the impairment of capital. The company treated these earnings as "undivided profits" constituting part of its "invested capital", but the Commissioner held that the amount did not constitute "undivided profits" on the ground that the earnings for 1918 and 1919 should be applied to reduce the impairment of capital.

This Court held that the earnings of 1918 and 1919 must be applied to reduce the impairment of capital. In

discussing the terms "surplus" and "undivided profits" this Court said (p. 218):

> "* * * the distinction between these terms, as commonly employed, is that the term 'surplus' describes such part of the excess in the value of the corporate assets as is treated by the corporation as part of its permanent capital, usually carried on the books in a separate 'surplus account'; while the term 'undivided profits' designates such part of the excess as consists of profits 'which have neither been distributed as dividends nor carried to surplus account.' *Edwards v. Douglas, supra,* 214. But it is a prerequisite to the existence of 'undivided profits' as well as a 'surplus', that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute 'undivided profits.'"

Although the decision of this Court in the *Milton Dairy Co.* case dealt with the determination of "undivided profits" for excess profits tax purposes the principle expressed is equally applicable to the determination of "earnings or profits" for income tax and undistributed profits tax purposes. In fact, the case has frequently been cited as authority in that connection.[4] We believe the

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[4]See *Foley Securities Corp. v. Commissioner,* infra. See also *Helvering v. Canfield,* 291 U. S. 163, 166 (1934); *Van Norman Co. v. Welch,* 141 F.2d 99, 102 (CA-1, 1944); *Commissioner v. W. S. Farish & Co.,* 104 F.2d 833, 834 (CA-5, 1939); cert. den. *Blaffer v. Commissioner,* 308 U. S. 559; *Hadden v. Commissioner,* 49 F.2d 709, 711 (CA-2, 1931); *Chapman v. Anderson,* 11 Fed. Supp. 913, 914 (Dist. Ct. N.Y., 1935); *Kinnear, Roy J.,* 36 B.T.A. 153, 155 (1937); *Sale, Loren D.,* 35 B.T.A. 938, 939 (1937); *Washburn, J. L.,* 16 B.T.A. 1091, 1098 (1929). In addition to the foregoing see the decision of the Tax Court in the instant case. (R. 77.)

Milton Dairy Co. case to be clear authority for the proposition that a corporation cannot accumulate earnings or profits for any period, whether the period commences at March 1, 1913 or any other time, without first restoring an impairment of capital. Consequently we believe that the decision of the Court below in the instant case is in direct conflict with the decision of this Court in *Willcuts v. Milton Dairy Co.*, but in any event it is in conflict with the general principle expressed in that case.

(b) The decision below conflicts in principle with Helvering v. Canfield, 291 U. S. 163.

Fundamentally, the decision of the Court below involves the concept that a line is drawn on March 1, 1913 and that a new start is made on that date, everything on the other side of the line being ignored. In fact, the Court said "Congress drew a line between February 28, 1913 and March 1, 1913." But in *Helvering v. Canfield,* 291 U.S. 163 (1934), this Court decided that no such impenetrable line exists. In that case the corporation had an earned surplus of some $4,000,000 on March 1, 1913, a profit of about $4,000 in 1914, a loss of over $190,000 in 1915, a loss of over $200,000 in 1916, and profits thereafter. The question involved was whether, in determining "earnings or profits accumulated since February 28, 1913," (section 201(a), Act of 1921; 42 Stat. 228) the excess of the losses of 1915 and 1916 over the small profit of 1914 should be deducted from profits subsequent to 1916. The taxpayer contended that the statute created two distinct periods, that before March 1, 1913 and that after March 1, 1913, and that the accumulations for each period constituted a "fixed and static amount". He ac-

cordingly concluded that the losses of 1915 and 1916 must be deducted from subsequent profits. But this Court held that the losses of 1915 and 1916 reduced the earned surplus existing on March 1, 1913 and should not be deducted from subsequent profits. Thus the "earnings or profits accumulated after February 28, 1913" were determined to be greater than the balance of gains or losses since that date. Therefore this Court held in the *Canfield* case that the words "earnings or profits accumulated after February 28, 1913" cannot be interpreted to mean a mere balancing of gains and losses since that date, which is the basic concept of the decision below.

But the question discussed in the *Canfield* case is even closer to the question presented in the instant case than the facts disclose. The taxpayer argued that if the losses of 1915 and 1916 reduced the earned surplus on March 1, 1913, then there had been *an impairment of March 1, 1913 capital which should be restored out of profits subsequent to 1916.* And the taxpayer supported this argument by citing the statutory provision (section 201(b), Act of 1921; 42 Stat. 228) that pre-1913 earnings may be distributed exempt from tax after post-1913 earnings have been distributed. Thus, the taxpayer argued, the statute treats the March 1, 1913 earned surplus as capital and its impairment must be restored out of subsequent earnings. With respect to this question, which was thus presented for decision, this Court said:

> "The argument that the surplus of March 1, 1913, constituted capital is unavailing. We are not here concerned with capital in the sense of fixed or paid-in capital, *which is not to be impaired, or with the restoration of such capital where there has been im-*

pairment. No case of impairment of capital is presented." (Italics added.)

It is submitted that the decision of the Court below that the impairment of capital existing on March 1, 1913 need not be restored conflicts with the principles expressed by this Court in *Helvering v. Canfield.*

2. **THE DECISION BELOW CONFLICTS, AT LEAST IN PRINCIPLE, WITH THE DECISION OF THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT IN FOLEY SECURITIES CORP. v. COMMISSIONER, 106 F.2d 731.**

The question involved in *Foley Securities Corp. v. Commissioner,* 106 F. (2d) 731 (C.A. 8, 1939) was the amount of the deduction to be allowed for "dividends paid" in the computation of the surtax on personal holding companies. The Foley Company, which was organized in 1928, was a "personal holding company" within the meaning of section 351 of the Revenue Act of 1934 (48 Stat. 680, 751), which imposed a surtax upon the "undistributed adjusted net income" of such a corporation. At the beginning of 1934 the company had an operating deficit of $23,650.53. Its adjusted net income for the year 1934 was $49,909.52, and it distributed to its stockholders $42,375. In the computation of the "undistributed adjusted net income" upon which the surtax was based a deduction was allowed (section 351(b)(2)(C)) for "dividends paid during the taxable year". Section 351(b)(4) reads: "The terms used in this section shall have the same meaning as when used in Title I." The company contended that the full amount of the distributions made during the year, $42,375, should be allowed as a deduction for "dividends paid". The Commissioner allowed as a

deduction, however, only $26,258.99. This was the amount available for a dividend after deducting the operating deficit of $23,650.53 at the beginning of the year from $49,909.52, the income earned during the year.[5]

The Court cites several Board of Tax Appeals decisions in support of the statement that the Board has uniformly construed the definition of a dividend "to mean a distribution made to shareholders out of *earned surplus* accumulated since February 28, 1913". (Italics added.)

The Court then said (p. 733):

> "The taxpayer had, at the time it made the distribution of $42,375 to its shareholders, an *earned surplus* of $26,258.97 available for the payment of a 'dividend'. Therefore, when it distributed $42,375 to its shareholders, only $26,258.97 was a 'dividend' under the ruling of the Board, *and the balance was a distribution of capital not taxable to the shareholders, but which went to reduce the adjusted basis of their stock.* * * *" (Italics added.)

The Court quoted from the decision of this Court in *Willcuts v. Milton Dairy Co.*, 275 U.S. 215, 218, as follows:

> "* * * But it is a prerequisite to the existence of 'undivided profits' as well as a 'surplus,' that the net assets of the corporation exceed the capital stock. Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute 'undivided profits.'"

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[5]It appears that in this case the "adjusted net income" was equal to the actual income for the year.

The Court held that the Board of Tax Appeals was correct in deciding that the operating deficit at the beginning of the year must be restored and consequently only $26,258.97 out of the distribution of $42,375 constituted a "dividend". Although the operating deficit in this case arose after 1913, the company having been incorporated in 1928, it is clear that this factor was of no moment whatever and that the same conclusion would have been reached irrespective of when the operating deficit arose. The decision of the Court was based, in part at least, upon the broad general principle expressed by this Court in the *Milton Dairy* case, *supra*, that there cannot be "undivided profits" where the capital is impaired, which principle the Court apparently considered equally applicable to the ascertainment of "earnings or profits" available for dividends.

Thus the Court in the *Foley* case decided that the impairment of capital must be restored, not because the impairment arose after March 1, 1913, *but because there was an impairment.* But in the instant case the Court below decided that the impairment of capital need not be restored.

It is accordingly submitted that the decision below conflicts, at least in principle, with the decision of the Court of Appeals for the Eighth Circuit in *Foley Securities Corp. v. Commissioner.*

3. **THE COURT OF APPEALS HAS DECIDED AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT.**

The petitioners advanced the alternative argument in the Court of Appeals that the Commissioner, under his

construction of section 115(a)(1) of the Internal Revenue Code, is asserting a tax upon the receipt of distributions made by a corporation with an impaired capital and no undistributed earnings of the current year. It was contended that such distributions do not constitute income to the recipient within the meaning of the Sixteenth Amendment to the Constitution granting to Congress the power "to lay and collect taxes on incomes" (Appendix, p. i) and that a tax imposed upon the receipt of such distributions is accordingly a tax violative of Section 2 of Article I of the Constitution (Appendix, p. i) as constituting a direct tax not apportioned among the several states. (*Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 637.) The Court disposed of petitioners' contention on this point by assuming that such distributions constituted income—the question at issue. Accordingly the Court held that there was no merit in petitioners' contention.

It is not our purpose at this time to enter into an extended argument that distributions made by a corporation with an impaired capital constitute a return of capital and are not income in the constitutional sense. For the purposes of this petition we believe it will be sufficient to show that the decisions of this Court, while not directly passing upon the question, indicate clearly that a distribution, in order to constitute income to the stockholder, must be a distribution from something other than the capital of the corporation—a distribution either from profits or from increase in value of corporate assets. The capital of a corporation with which it transacts business is the capital paid in by the stockholders, and any distribution to the stockholders of this capital is a return to them of the capital contributed by them.

In *Lynch v. Hornby,* 247 U.S. 339 (1918), this Court had before it the question whether, under the statute and under the Constitution, distributions made by a corporation in 1914 from a surplus of corporate assets existing on March 1, 1913 constituted taxable income to the stockholders. This Court said (pp. 343-4):

> "* * * And we deem it equally clear that Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had *in a surplus of corporate assets* previously existing. * * *" (Italics added.)

This Court, in *Eisner v. Macomber,* 252 U.S. 189 (1920), decided that a true stock dividend is not income within the meaning of the Sixteenth Amendment. Four justices dissented, being of the opinion that a stock dividend does constitute income. Mr. Justice Brandeis, in his dissenting opinion, which of course gave a broader construction to the term "income" than the majority opinion, said (pp. 226-7):

> "* * * The term 'income' when applied to the investment of the stockholder in a corporation, had, before the adoption of the Sixteenth Amendment, been commonly understood to mean the returns from time to time received by the stockholder *from gains or earnings of the corporation.* A dividend received by a stockholder from a corporation may be either

in distribution of capital assets or in distribution of profits. Whether it is the one or the other is in no way affected by the medium in which it is paid, nor by the method or means through which the particular thing distributed as a dividend was procured. * * * How the money shall be raised is wholly a matter of financial management. The manner in which it is raised in no way affects the question whether the dividend received by the stockholder is income or capital; nor can it conceivably affect the question whether it is taxable as income." (Italics added.)

and at pages 237-8:

"* * * It seems to me clear, therefore, that Congress possesses the power which it exercised to make dividends *representing profits,* taxable as income, whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends *representing profits* shall be deemed income. * * *" (Italics added.)

We have previously discussed the decision of this Court in the *Canfield* case, *supra,* pp. 18-20. In the course of its opinion in that case this Court said (p. 167):

"* * * When a corporation continued in business after March 1, 1913, the dividends it later declared and paid to its stockholders, *whether out of current earnings or from profits accumulated prior to that date, constituted income to the stockholders, and not capital,* and were taxable as income if the Congress saw fit to impose the tax. Lynch v. Hornby, 247 U.S. 339. The provision of the Act of Congress under consideration was a 'concession to the equity of stockholders' with respect to receipts *as to which they had no constitutional immunity. There is no question here of the receipt of 'capital.'* " (Italics added.)

Congress has also clearly indicated that, in its opinion, a corporate distribution is a return of capital to the stockholders if it is not paid out of earnings or based upon an increased value of corporate assets. The Revenue Act of 1924 contained section 201(d) (43 Stat. 253, 255) (Appendix, p. ii), reading in part as follows:

> "(d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, *and is not out of earnings or profits,* then the amount of such distribution shall be applied against and reduce the basis of the stock * * *." (Italics added.)

The Congressional Committee reports on the Revenue Bill of 1924 of both the House and the Senate (H. Rep. No. 179, 68th Cong., 1st Sess., p. 12; S. Rep. No. 398, 68th Cong., 1st Sess., p. 12; reprinted in 1939-1 (Part 2) C. B. 250, 274) contain the following explanation of this provision:

> "This subdivision provides that amounts distributed by a corporation *which do not constitute distributions of earnings or profits* or increase in value of property accrued prior to March 1, 1913 * * * *constitute a return of capital* to the stockholder * * *." (Italics added.)

A brief discussion of the merits, which includes the subsequent statutory history of section 201(d) of the Act of 1924, just referred to, follows.

II. A BRIEF DISCUSSION OF THE MERITS.

The only case which has squarely decided the question as to whether or not an impairment of capital caused by pre-March 1, 1913 operating losses must be restored by subsequent earnings or profits is *Chapman v. Anderson,* 11 Fed. Supp. 913 (D.C. N.Y. 1935). In that case a corporation had an operating deficit of $957,235.15 on March 1, 1913. Subsequent to 1913 it had substantial earnings and it declared three dividends of $80,000 each on March 2, 1925, July 15, 1925 and January 12, 1926. The taxpayer-plaintiff argued that as of the dates of the two dividends declared in 1925 the deficit as of March 1, 1913 had not yet been completely eliminated by subsequent earnings, and that it was not until the dividend of January 12, 1926 that the deficit as of March 1, 1913 had been completely eliminated, there being on that date a surplus of $48,845.92. Accordingly, the plaintiff contended that of the three dividends totalling $240,000 only $48,845.92 was subject to tax. The government contended that appreciation in value of the corporation's assets as of March 1, 1913 in the amount of $274,838.97 should be applied in reduction of the operating deficit of $957,235.15, with the result that such operating deficit would have been eliminated by subsequent earnings prior to the dividend declared on March 2, 1925, and that therefore all three dividends were fully taxable. The Court first considered the question as to whether the March 1, 1913 operating deficit had to be restored by subsequent earnings, since if it did not, it was immaterial whether the unrealized appreciation did or did not reduce the operating deficit. After quoting section 201(a) of the Act of

1926 (44 Stat. 10), defining the term "dividend" to mean distributions out of "earnings or profits accumulated after February 28, 1913," the Court quotes section 201(d) as follows:

> "(d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, *and is not out of earnings or profits,* then the amount of such distribution shall be applied against and reduce the basis of the stock * * *." (Italics added.)[6]

The Court then came to the conclusion that the operating deficit must be restored, stating that

> "*It seems clear that, unless an operating deficit or impairment of capital has been made good out of subsequent earnings or profits, any distribution of (on) stock is not a 'dividend'* under 26 USCA § 932, *supra.*" (Italics added.)

Having concluded that the operating deficit as of March 1, 1913 must be restored by subsequent earnings before the corporation could have any accumulated earnings or profits available for dividends, the Court considered the second question involved in the case and determined that the March 1, 1913 deficit did not have to be reduced by the unrealized appreciation as of March 1, 1913. Accordingly the Court held that of the three dividends totalling $240,000, only $48,845.92 was subject to tax, this being

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[6]The Court does not comment upon this statutory provision but its significance is plain, viz., if a distribution is not out of earnings or profits it reduces the basis of the stock because it is a capital distribution. Hence there must be earnings or profits in order to have a taxable dividend.

the amount of earnings available after the elimination of the entire operating deficit as of March 1, 1913 by subsequent earnings. The Court thus held squarely that the operating deficit as of March 1, 1913 had to be restored by subsequent earnings or profits before there were any *accumulated* earnings or profits available for dividends.[7]

The following statement appears in Mertens "Law of Federal Income Taxation," paragraph 9.30, Volume I, page 463:

> "* * * *An impairment of capital by an operating deficit accumulated prior to March 1, 1913, must be made good, however, out of subsequent earnings.* It is immaterial that although an operating deficit existed at March 1, 1913, the corporation had substantial unrealized increase in value of its properties on that date. * * *" (Italics added.)

Paragraph 9.30 of Mertens, in which the foregoing quotation appears, is cited by this Court in *Commissioner v. Phipps*, 336 U.S. 410 (1949). In that case this Court made the following statement (p. 418):

> "* * * Briefly stated, in the case of a distribution to a corporation with a deficit from either current or prior losses, the corporation receiving the distribution has no * * * earnings or profits available for current distribution until current income exceeds current

[7]It is true that the government did not contend in this case that the operating deficit did not have to be restored, but this merely tends to show that at this date (1935) the government considered the principle to be established that all impairments of capital, whether before or after 1913, must be restored. See, for example, General Counsel's Memorandum 1552, VI-1 C. B. 10 (1927), in which it is stated "there can be no accumulation of profits until an operating deficit is made good. As there was no surplus from which a dividend could have been paid, it necessarily follows that the distribution must have been out of capital."

losses, *and no accumulated earnings or profits until its actual deficit from prior losses is erased.* See 1 Mertens, Law of Federal Income Taxation (1942) § 9.30, and cases cited therein n. 44 *et seq.* * * *" (Italics added.)

Section 201(d) of the 1926 Act (44 Stat. 11), which was relied upon by the Court in *Chapman v. Anderson, supra,* first appeared as section 201(d) of the 1924 Act. We pointed this out on page 26, *supra,* and there set forth the Congressional Committee reports relating to this section, in which it is stated that "amounts distributed by a corporation which do not constitute distributions of earnings or profits * * * constitute a return of capital to the stockholder * * *."

Section 201(d) of the 1924 Act was repeated in substantially the same form so far as here material as section 201(d) in the Act of 1926 and as section 115(d) in the Acts of 1928, 1932 and 1934. (Appendix, pp. ii to iii.) Thus at least during the period 1924 to 1935, both inclusive, covering five major Revenue Acts, the existence of earnings or profits was an essential prerequisite to the declaration of a taxable dividend. It follows that under those Acts the statutory definition of a dividend must be interpreted so that a distribution made while a corporation has no earnings or profits, in other words, while its capital is impaired, does not come within the definition.

However, in 1936 Congress embarked upon the experiment of imposing a graduated surtax on the undistributed net income of corporations.[8] (Section 14, Revenue Act of

[8]This tax, which was designed to force corporations to distribute their profits, proved to be impracticable and was abandoned, there being no similar tax enacted with the succeeding Revenue Act in 1938.

1936, 49 Stat. 1655.) In the computation of the "undistributed net income" a deduction was allowed by section 14(a)(2) for the "dividends paid credit provided in section 27" and that section allowed a credit for "the amount of dividends paid during the taxable year" (49 Stat. 1665). Accordingly, a corporation which had an operating deficit at the beginning of the year would find itself subject to this surtax upon an amount of its net income equal to the operating deficit even though it distributed the full amount of its net income, since such distributions would not constitute "dividends" except to the extent of the earnings or profits remaining after the restoration of the operating deficit. (See *Foley Securities Corp. v. Commissioner, supra,* pp. 20-22.)

In order to avoid this inequitable result Congress simultaneously amended section 115(a) (49 Stat. 1687) defining the term "dividend" by adding a new provision by which distributions from the earnings or profits of the taxable year were subjected to tax as a dividend without regard to the existence of an operating deficit at the beginning of the year. After this addition, the pertinent portion of the definition of a dividend, as contained in section 115(a) of the Acts of 1936 and 1938 and the Internal Revenue Code (Appendix, p. iv), read as follows:

> "(a) Definition of Dividend.—The term 'dividend' when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions

made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

This addition to the definition of a dividend in turn necessitated a change in section 115(d), relating to the reduction of basis if a distribution is not out of "earnings or profits." Since the basis of the stockholder's stock should not be reduced if he was subjected to tax on the distribution, and since under the new addition to the definition of a dividend a distribution out of the current earnings of the taxable year would be taxed as a dividend even though, because of an operating deficit, the corporation had no "earnings or profits," it became necessary to change the words "and is not out of earnings or profits" in section 115(d) to read "and is not a dividend." After this change the pertinent portion of section 115(d) of the Acts of 1936 and 1938 and the Internal Revenue Code (Appendix, p. iv) read as follows:

> "(d) Other Distributions From Capital.—If any distribution * * * made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock * * *."

Since the forerunner of this section, namely, section 201(d) of the Acts of 1924 and 1926, and section 115(d) of the Acts of 1928, 1932 and 1934, were relied on to show that before there can be any "earnings or profits accumulated after February 28, 1913" it is essential to have "earnings or profits," it became necessary to explain the

change which was made in this section and the reasons which led to the change. But neither this change nor the addition of part (2) to the definition of a dividend can have any possible effect upon the meaning of the words contained in part (1) of the definition, which continued unchanged in the Revenue Acts of 1936 and 1938 and in the Internal Revenue Code. Certainly it cannot be assumed that Congress, having repeated the identical words, intended to change their meaning. This was recognized by counsel for the Commissioner in the Court below, who contended that under the Revenue Acts prior to 1936, as well as under the later Acts and the Code, the existence of earnings or profits is *not* an essential prerequisite to the declaration of a taxable dividend and that it was not necessary under any of the Revenue Acts to restore an impairment of capital caused by pre-March 1, 1913 operating losses.

For the reasons set forth under the first subdivision hereof, pages 16 to 26, it is respectfully submitted that a writ of certiorari should issue as prayed for in the petition submitted herewith.

Dated, San Francisco, California,
February 20, 1952.

LEON DE FREMERY,
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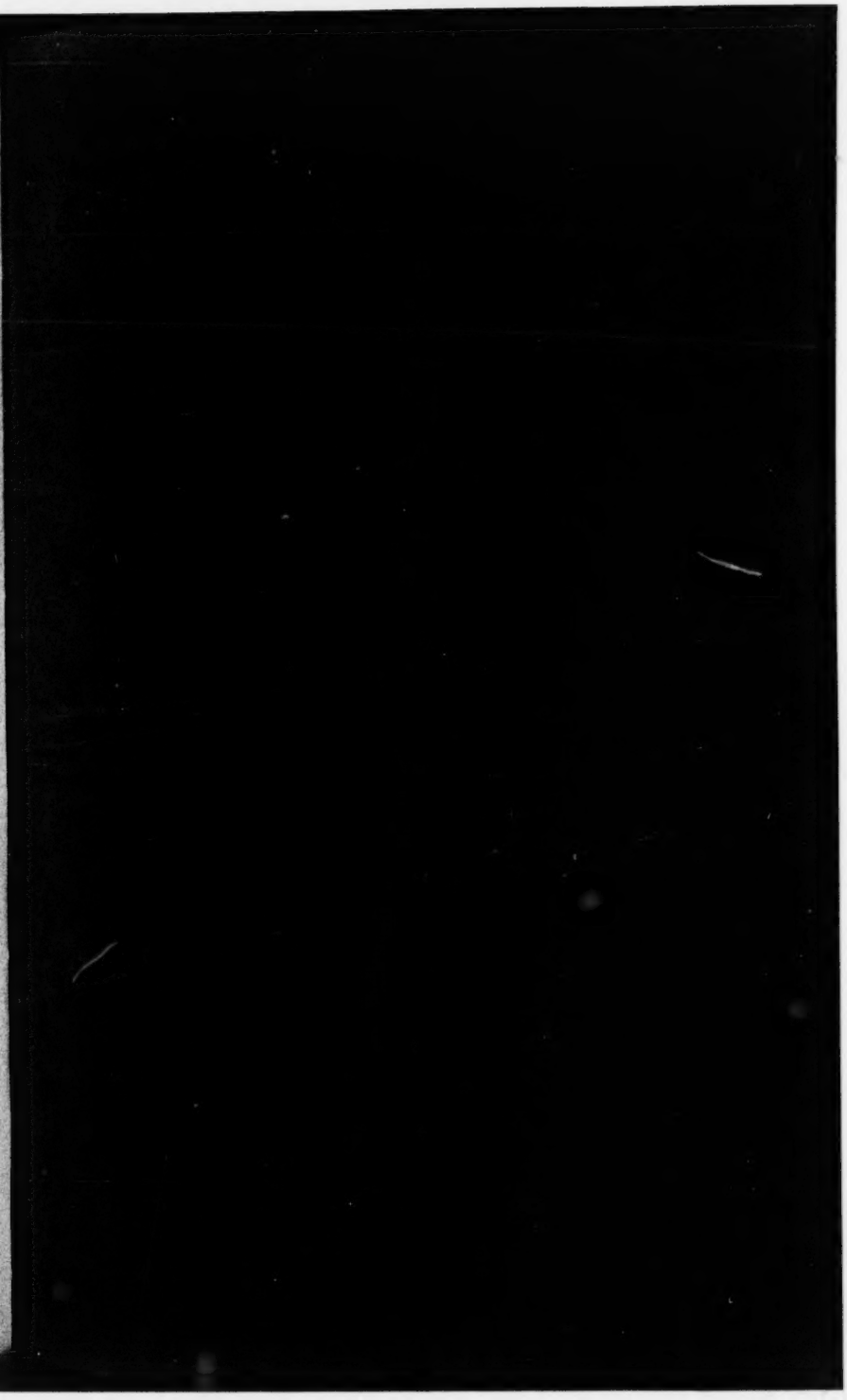
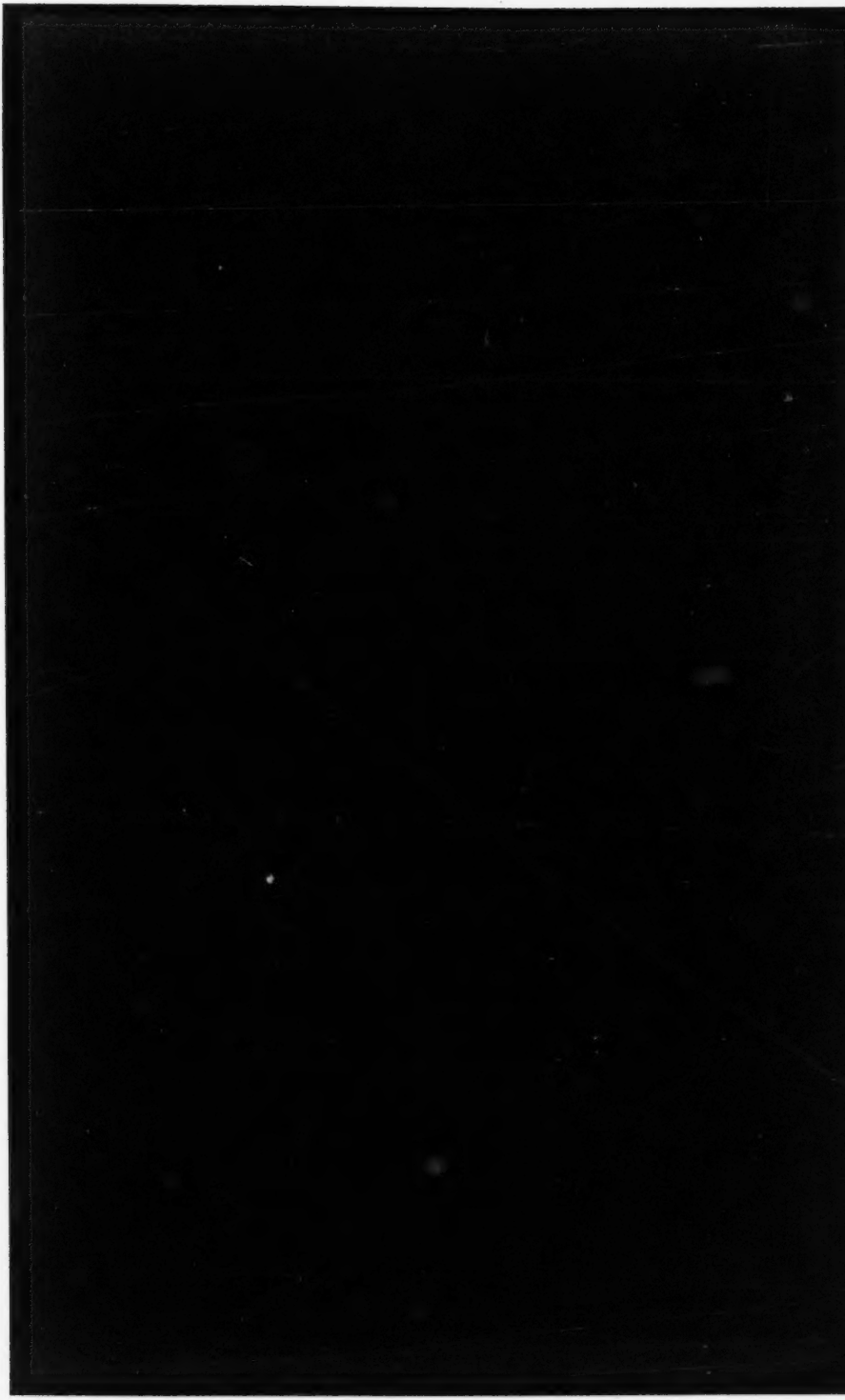
(Appendix Follows.)





Appendix

CONSTITUTION OF THE UNITED STATES.

Article I.

Section 2. * * *

Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, * * *.

Amendment XVI.—Income Tax.

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

STATUTORY PROVISIONS.

Judicial Code, Section 240(a) as amended by Act of February 13, 1925, 43 Stat. 938, 28 U.S.C.A., Section 347.

(a) In any case, civil or criminal, in a circuit court of appeals, or in the Court of Appeals of the District of Columbia, it shall be competent for the Supreme Court of the United States, upon the petition of any party thereto, whether Government or other litigant, to require by certiorari, either before or after a judgment or decree by such lower court, that the cause be certified to the Supreme Court for determination by it with the same power and authority, and with like effect, as if the cause had been brought there by unrestricted writ of error or appeal.

Revenue Acts of 1924 and 1926, Section 201(d) (43 Stat. 253, 255; 44 Stat. 9, 11).

Sec. 201. (d) If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 204, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. The provisions of this paragraph shall also apply to distributions from depletion reserves based on the discovery value of mines.

Revenue Act of 1928, Section 115(d) (45 Stat. 791, 822).

Sec. 115. (d) **Other distributions from capital.**—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. The provisions of this subsection shall also apply to distributions from depletion reserves based on the discovery value of mines.

Revenue Act of 1932, Section 115(d) (47 Stat. 169, 204).

Sec. 115. (d) **Other distributions from capital.**—If any distribution (not in partial or complete liquidation) made

by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

Revenue Act of 1934, Section 115(d) (48 Stat. 680, 711).

Sec. 115. (d) **Other Distributions from Capital.**—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

Revenue Act of 1936, Section 112(b)(6) (49 Stat. 1648, 1679).

Sec. 112. (b) (6) **Property Received by Corporation on Complete Liquidation of Another.**—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. For the purposes of this paragraph a distribution shall be considered to be in complete liquidation only if—

(A) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and

has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 per centum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), * * *.

Revenue Acts of 1936 and 1938 and Internal Revenue Code, Section 115(a) (49 Stat. 1687; 52 Stat. 447, 496).*

Sec. 115. (a) **Definition of Dividend.**—The term "dividend" when used in this title (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Revenue Acts of 1936 and 1938, Section 115(d) (49 Stat. 1688; 52 Stat. 447, 497).

Sec. 115. (d) **Other Distributions from Capital.**—If any distribution (not in partial or complete liquidation) made

*Section 115(a) of the Internal Revenue Code contains an additional sentence at the end thereof relating to personal holding companies.

by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.